Petition

81-355

Office-Supreme Court, U.S.
FILED
AUG 7 1981
ALEXANDER L. STEVAS,
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM 1981

No. ....

JOSEPH E. AND SALLY RUSSO,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE FIFTH CIRCUIT

MELVIN M. ENGEL
LADIN & ENGEL
One West Loop South,
Suite 809
Houston, Texas 77027
Attorneys for Petitioners

August 1981

QUESTIONS PRESENTED

In March 1969 a shareholder entered into an agreement whereby the corporation agreed to pay the shareholder for the redemption of his shares in accordance with an agreement entered into by all shareholders of the corporation in January 1968 to facilitate the orderly disposition of shares should a shareholder so desire. The shareholder for the years in question reported the amounts received as a result of the redemption as proceeds from the sale of his shares, entitled to capital gains treatment.

The question presented here is whether the proceeds received by the shareholder under the terms of the agreement were received in exchange for his shares and entitled to capital gains treatment on his tax returns.

INDEX

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Constitutional Provisions, Statutes and Rules of Court Involved	2
Statement of the Case	3
Reasons for Granting the Writ	4
Conclusion	7
Appendix A (Opinion of Court of Appeals)	A-1
Appendix B (Opinion of United States Tax Court)	B-1

CASE CITATIONS

Commissioner v. Danielson, 378 F.2d 771,775 (3d Cir. 1967, revg. 44 T.C. 549 (1965)	4, 5, 6
Schmitz v. Commissioner, 51 T.C. 306, 318 (1968), affd. 457 F.2d 1022 (9th Cir. 1972)	4
Steffen v. Commissioner, 69 T.C. 1049 (1978)	6

IN THE

Supreme Court of the United States

OCTOBER TERM 1981

No. ....

JOSEPH E. AND SALLY RUSSO,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE FIFTH CIRCUIT

The petitioners, JOSEPH E. and SALLY RUSSO, pray that a writ of certiorari issue to review the opinion and judgment of the United States Court of Appeals for the Fifth Circuit rendered in these proceedings on May 11, 1981.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit, unreported, appears at Appendix A, infra, pp. A-1-A-5. The opinion of the United States Tax Court appears at 79497 P-H MEMO TC and appears at Appendix B, infra, pp. B-1-B-19. The United States Court of Appeals for the Fifth Circuit affirmed the judgment of the United States Tax Court.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was entered on May 11, 1981. See Appendix A, pp. A-1-A-5, infra. An Order for an extension of time in which to file this petition was signed on July 8, 1981 by Justice Powell, extending the time to file this petition to and including August 9, 1981. This petition for certiorari was filed less than 90 days from the date aforesaid. The jurisdiction of this Court is invoked on 28 U.S.C. §1254.

QUESTIONS PRESENTED

In March 1969 a shareholder entered into an agreement whereby the corporation agreed to pay the shareholder for the redemption of his shares in accordance with an agreement entered into by all shareholders of the corporation in January 1968 to facilitate the orderly disposition of shares should a shareholder so desire. The shareholder for the years in question reported the amounts received as a result of the redemption as proceeds from the sale of his shares, entitled to capital gains treatment.

The question presented here is whether the proceeds received by the shareholder under the terms of the agreement were received in exchange for his shares and entitled to capital gains treatment on his tax returns.

CONSTITUTIONAL PROVISIONS, STATUTES AND RULES OF COURT INVOLVED

This case involves Section 302(a) of the Internal Revenue Code of 1954, as amended, which provides in pertinent part as follows:

Section 302 Distributions In Redemption of Stock

> "(a) General Rule — If a corporation redeems its stock . . . such redemption shall be treated as a distribution in part or full payment in exchange for the stock."

STATEMENT OF THE CASE

Russo/Shindler, Cummins, Inc. (RSC) was a corporation engaged in obtaining long-term leases for property owners. For such services RSC received commissions spread over the term of the lease. In 1967 the Petitioner, JOSEPH E. RUSSO (Russo), owned forty percent (40%) of the outstanding shares of stock in RSC. In 1967 RSC had Deferred Commissions Receivable from such leases in the amount of $708,473.00. In order to allow three new stockholders into the firm without the new stockholders paying the value of the Deferred Commissions Receivable, the three existing stockholders entered into a plan whereby each would receive their share of the Deferred Commissions Receivable. In furtherance of this plan the three existing stockholders entered into a contract on October 1, 1967, which they styled Employment Contract, whereby each of them would receive, in addition to other compensation, an amount which approximated their share of the Deferred Commissions Receivable. On January 10, 1968, all of the stockholders, the three existing stockholders plus the three new stockholders, entered into an agreement with RSC styled a Stock Purchase Agreement. Under the terms of the Stock Purchase Agreement a stockholder who wanted to sell his shares of stock would be paid an amount computed by a formula contained therein. Part of that formula for determining the Value Per Share was an amount equal to the balance due under the so-called Employment Contract or the stockholders share of the pre-October 1, 1967 Deferred Commissions Receivable. On March 9, 1969, Russo entered into an agreement dated February 27, 1969, whereby he agreed to a redemption of his RSC stock to RSC. Russo received an amount computed under the terms of paragraph II-B of the February 27, 1969 redemption agreement. Paragraph II of the redemption agreement is entitled "Consideration". Russo reported the entire amounts received during 1970, 1971, 1972, and 1973 under the terms of the Redemption Contract as proceeds from the sale of the

capital stock. The Respondent (Government) recharacterized $256,000.00 out of the total of $364,719.78 as ordinary income resulting from the termination of an employment contract. The United States Tax Court agreed with the Government and the United States Court of Appeals for the Fifth Circuit affirmed such decision.

REASON FOR GRANTING THE WRIT

The flow of commerce should not be restricted by allowing the Internal Revenue Service to re-characterize the bargained for tax consequences between two taxpayers by giving one taxpayer a deduction he had not bargained for, and taking away from the other taxpayer the very tax advantage he had bargained for, unless there is a showing the transaction was not at arms-length, was a sham, or had no purpose other than to avoid taxes.

The two taxpayers in this instance, Russo and RSC, entered into a stock redemption agreement. The tax consequences of a stock redemption agreement result in the sale of a capital asset to the seller and no deduction to the purchaser. This was the arms-length, bargained-for tax result both parties accepted when they entered into the agreement. They did so knowingly, with advice of counsel, and had every reason to be able to rely on such result. At the current rate of taxation, the tax consequences are an important part of every business transaction. Unless the Internal Revenue Service can show the transaction was not at arms-length, was a sham, or had no purpose other than to avoid taxes, the transaction should be allowed to stand.

In the instant case the Revenue Agent shifted the focus from the stock redemption agreement, which triggered the tax consequences, to an agreement which had been superceded, by the later agreements, and succeeded in convincing the Court below that the petitioner either had the burden of the "strong proof" rule, *Schmitz* v. *Commissioner*, 51 T.C. 306, 318 (1968), aff'd. 457 F.2d 1022 (9th Cir. 1972), or the "Danielson rule", *Commissioner* v. *Danielson*, 378 F.2d 771, 775 (3d Cir. 1967, revg.

44 T.C. 549 (1965). To apply either rule is clearly erroneous. It was the Commissioner of Internal Revenue who attacked the form of the stock redemption agreement selected by the parties. The stock redemption agreement clearly sets out the amount paid to the petitioner as consideration for his stock. In *Danielson,* the thrust of the decision is "to hold the taxpayer to his agreement".

It is not the petitioner here who is disavowing the agreement that gave rise to the taxable transaction, it is the Commissioner. In this case the Commissioner is taking away the bargained-for tax advantage of the petitioner and granting an unexpected salary deduction to a taxpayer who had bargained it away.

The Courts below have failed to answer one important question that is the crux of this matter. If the so-called Employment Contract was still in effect at the time of transaction in question, why was there any need for any mention thereof in the Stock Purchase Agreement or the Stock Redemption Agreement? If the decisions are correct the petitioner would have received the amount due under the terms of the Employment Contract, for termination of that contract, and he would have received the consideration for his stock from the Stock Purchase Agreement. Under the reasoning of the lower Courts there was no need for any "Employment Contract" provisions in the latter two agreements; such rights were covered in the prior agreement. Does this not conclusively show that the prior agreement had been superseded by the latter agreements? Does this not conclusively show the petitioner was paid the consideration as shown in the latter agreements for his stock and not for the termination of employment? There is nothing in the record to show otherwise.

When two parties enter into an agreement in which one accepts as part of the bargain a tax disadvantage, and the other bargains for and obtains a tax advantage, the parties should be able to plan and rely on such tax consequences, and such consequences should be allowed to stand unless there is a showing that

the dealing was not at arms-length, was a sham, or had no purpose other than to avoid taxes. The dictates of a smooth flow of commerce require such a rule.

The petitioner contends that the instant case should have been decided on the basis of *Steffen* v. *Commissioner*, 69 T. C. 1049 (1978), and that neither the "strong-proof rule" nor the "Danielson rule" should have been applied by the Courts below. These rules, however, were applied, and the petitioner would respectfully call the attention of this Court to the conflicts between the various Circuits, and between some of the Circuits and this Court. It would appear that the Court of Appeals for the First, Second, Fourth, Ninth and Tenth Circuits follow the "strong-proof rule", while the Court of Appeals for the Third, Fifth and Sixth Circuits have followed the "Danielson rule." The Court of Appeals for the Seventh and Eighth Circuits have rejected both rules. As pointed out in the dissenting opinion in *Danielson*, such rules have "have disregarded a long line of decisions of the United States Supreme Court holding to the contrary". *Danielson*, supra. The question presented is of importance to the proper administration of the federal tax laws. The settlement of this question by this Court is in the public interest because the petitioners' case is representative of a problem confronting many taxpayers.

CONCLUSION

For the reasons stated above, the decision of the Court of Appeals in the instant case raises a question of general importance in the administration of the tax laws which should be reviewed by this Court. We believe that it is in the public interest that the tax consequences of commercial transactions remain intact unless there is a compelling reason to re-characterize such transactions and that such a reason is lacking in the instant case.

Respectfully submitted,

s/ MELVIN M. ENGEL
MELVIN M. ENGEL

LADIN & ENGEL
One West Loop South
Suite 809
Houston, Texas 77027
Telephone: (713) 623-6151

Attorneys for Petitioners

APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT
UNIT A

NO. 80-1628

JOSEPH E. RUSSO AND SALLY S. RUSSO,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

(May 11, 1981)

Before: CHARLES CLARK and RANDALL, Circuit Judges, and SHARP*, District Judge.

PER CURIAM:

In 1967, the taxpayer and two other individuals owned all the stock of Russo/Shindler, Cummins, Inc. ("RSC"). RSC was in the real estate business, and in 1967 it had deferred commissions receivable totaling $708,473. In order to permit three new stockholders to acquire a total of 25% of RSC's stock, a plan was devised to allow the new stockholders to purchase RSC stock at

---

* District Judge for the Northern District of Indiana, sitting by designation.

a price reflecting the value of RSC minus the deferred commissions receivable. In furtherance of this plan, on October 1, 1967, each of the three original stockholders (including the taxpayer) entered into an agreement with RSC, entitled "Employment Contract," in accordance with the terms of which he agreed to perform services for RSC and RSC agreed to pay stated amounts as compensation for services. In exchange for his services, the taxpayer was to be paid $2,000 per month until the employment contract expired on April 30, 1979. The total payments called for under the employment contract, $288,000, closely approximated the taxpayer's 40% interest in RSC's deferred commissions receivable. In the event of the taxpayer's death, payments were to be made to his estate until the scheduled expiration date of the employment contract. The taxpayer had the right to terminate the employment contract and, in such event, he would continue to receive a monthly payment (equal to 40% of all deferred commissions actually received by RSC up to a maximum of $2,000) in exchange for acting as an advisor and consultant to RSC.

Following the execution of the employment contracts between RSC and the three original stockholders, each of the original stockholders sold 25% of his stock to a new stockholder. Following this transaction, the taxpayer owned 30% of the stock of RSC and one of the new stockholders, James W. Gustafson, owned 10%.

On January 10, 1968, all six of the stockholders entered into a stock purchase agreement, in accordance with the terms of which RSC was granted a right of first refusal, followed by a right of refusal by the other stockholders, in the event any stockholder desired to dispose of his stock in RSC. In addition, any stockholder terminating his relationship with RSC was required by Section IV of the January 10, 1968 agreement to offer his stock for sale to RSC, and then to the other stockholders, at a price per share equal to the "Value Per

Share," as computed in Section V. Section V of that agreement defined "Value Per Share" as follows:

> *Value Per Share.* The term "Value Per Share" for shares of stock purchased and sold under this Agreement shall mean (i) the pro rata part of the base value $150,000.00, plus (ii) the pro rata part of the book value of the Company to the extent such book value exceeds $30,000.00 plus (iii) the pro rata part of the excess of the market value over the book value of all assets of the Company, including securities and real property but excepting furniture, fixtures, leasehold improvements, vehicles, good will and other personal property of the Company plus, (iv) the pro rata part of all deferred commissions allocated to and retained by the Company, after December 31, 1967, plus (v) the remaining amounts which would be due or would have been earned under any employment contract in force between the retiring or deceased stockholder had such stockholder survived and/or remained a stockholder and/or employee until the completion or expiration date of such employment contract; the employment contracts to which this provision specifically applies are those employment contracts executed between the Company and Joseph E. Russo, James C. Shindler and Edward J. Cummins, dated October 1, 1967.

Approximately one year after the stock purchase agreement was executed, the taxpayer decided to terminate his employment and stockholder relationship with RSC, and Gustafson decided to dispose of his RSC stock. Consequently, a Termination Agreement dated February 27, 1969, was executed among RSC, the taxpayer and Gustafson. Many topics were covered in the Termination Agreement, incuding the sale of the taxpayer's and Gustafson's stock and the termination of the taxpayer's employment contract. Article II, entitled "Purchase of Company Stock," provided for the purchase by RSC of the 1,875 shares owned by the taxpayer and the 625 shares owned by Gustafson at the "Value Per Share" computed as provided in the earlier Stock Purchase Agreement. The taxpayer also agreed that the

employment contract between RSC and the taxpayer was terminated.

Under the Termination Agreement, Gustafson was entitled to receive $36,243.27 for his RSC stock (constituting 10% of the outstanding RSC stock). Also under the Termination Agreement, the taxpayer was entitled to receive $364,729.79 for his RSC stock (constituting 30% of the outstanding RSC stock). This amount included $256,000 representing the unpaid balance under the employment contract.

The taxpayer received payments under the Termination Agreement in the amount of $54,600.00 in each of the years 1970, 1971 and 1972, and he received $81,900.00 in 1973. He reported the full amounts received as payments for the redemption of his stock, taxable as capital gain. The Commissioner, however, determined that $256,000.00 of the total $364,729.79 due the taxpayer constituted payment for the termination of his employment contract and, therefore, that the related portion of each year's receipts (78.12%) was ordinary income. The Tax Court sustained the Commissioner's determination. *Russo* v. *Commissioner*, 39 T.C.M. (CCH) 691 (1979). The taxpayer has appealed the adverse decision of the Tax Court. We affirm.

Amounts received by a selling stockholder in redemption of his stock are, generally, taxed as capital gain. I.R.C. § 302. Often, however, when a stockholder, who is also an employee of the company, terminates his interest in the company, the payment he receives from the company represents not only payment for his stock, but also consideration for services rendered or to be rendered. To this extent, the payments constitute ordinary income and not capital gain. I.R.C. § 61(a)(1). *Roscoe* v. *Commissioner*, 215 F.2d 478 (5th Cir. 1954). This is equally true where the payment, or a portion thereof, represents consideration for the cancellation or termination of an employment contract. *Roscoe* v. *Commissioner, supra; Wood* v. *Commissioner*, 34 T.C.M. (CCH) 817 (1975).

In this case, the taxpayer terminated his relationship with RSC. He sold all his stock back to RSC, and as part of the same transaction, terminated his employment contract under which he was due to be paid $256,000 over the remaining term. The taxpayer contends, on appeal, that this case involves only a sale of stock and that the entire amount he received from RSC is entitled to capital gains treatment. However, the Tax Court's finding that $256,000 of the $364,729.79 payable to the taxpayer under the Termination Agreement was paid for cancellation of a contract for services is judged under the clearly erroneous standard, and we hold that on the record in this case, the Tax Court's finding was not clearly erroneous. *Balthrope* v. *Commissioner*, 356 F.2d 28, 31 (5th Cir. 1966); *Roscoe* v. *Commissioner*, 215 F.2d at 481.

The taxpayer then argues that the employment contract was not really an employment contract but was instead a device to distribute to the stockholders of RSC on a pro rata basis corporate assets consisting of the deferred commissions receivable. In this circuit, "strong proof" has been required to overcome the parties' own declarations in an agreement. *See Sonnleitner* v. *Commissioner*, 598 F.2d 464, 467 (5th Cir. 1979); *Dixie Finance Co.* v. *United States*, 474 F.2d 501, 505 (5th Cir. 1973). Recently, this circuit adopted the even more stringent test enunciated by the Third Circuit in *Commissioner* v. *Danielson*, 378 F.2d 771 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967), which allows a party to challenge the form of an agreement only upon a showing of mistake, overreaching, duress or other reason which, in an action between the parties, would be sufficient to alter the agreement or set it aside. *See Spector* v. *Commissioner*, 641 F.2d 376, 385-86 (5th Cir. 1981). In this case, the Tax Court was correct in finding that the taxpayer had failed to present the "strong proof" contemplated by *Sonnleitner* and *Dixie Finance*. Further, there is no evidence in the record to support a finding of the sort contemplated by *Danielson*.

AFFIRMED.

APPENDIX B

T. C. MEMO. 1979-497

United States Tax Court

JOSEPH E. RUSSO AND SALLY S. RUSSO,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket Nos. 7193-76, 5523-77.

Filed December 11, 1979.

Melvin M. Engel, for the petitioners.

William D. Peltz, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SCOTT, *Judge*: Respondent determined deficiencies in the Federal income tax of petitioners are as follows:

Docket No.	Year	Deficiency
7193-76	1970	$ 4,953
7193-76	1971	9,295
7193-76	1972	25,203
5523-77	1973	20,460

Some of the issues raised by the pleadings have been disposed of by the parties, leaving for decision only whether moneys that petitioner, Joseph E. Russo, received from a corporation are attributable entirely to the redemption of his corporate stock, thereby qualifying for capital gains treatment under section

302(a), I.R.C. 1954,[1] or whether a portion of these amounts constitutes ordinary income received for termination of an employment contract.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners, Joseph E. Russo and Sally S. Russo, husband and wife, who resided in Houston, Texas at the time of filing their petition in this case, filed joint Federal income tax returns for the calendar years 1970, 1971, 1972, and 1973 with the Internal Revenue Service Center, Austin, Texas.

In 1967, the capital stock of Russo/Shindler, Cummins, Inc. (RSC) was owned by its three original shareholders as follows:

Shareholders	Number of Shares	Percentage Ownership
Joseph E. Russo	2,500	40 Percent
James C. Shindler	2,500	40 Percent
E. J. Cummins	1,250	20 Percent

On October 1, 1967, Messrs. Russo, Shindler, and Cummins executed separate agreements with RSC, each entitled "Employment Contract." The term of the agreements was from October 1, 1967, to September 30, 1979. Messrs. Russo, Shindler and Cummins each served as an executive officer of RSC.[2] Mr. Russo's contract provided in pertinent part:

---

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect in the years in issue.

[2] Article 2 of the "Employment Contract" required of each employee:

(a) To perform such duties and exercise such authority in such capacity as may be determined or assigned to him from time to time by the Board of Directors of the Company.

(b) To employ and use his best efforts to promote the business of the Company and to pursue diligently his duties and assignments at all times, employing and following such techniques in

3.

The compensation and consideration to be paid by Company to the Employee, and which the Employee agrees to accept from the Company for services performed and to be performed by the Employee hereunder, is and shall be the sum of *Twenty Four Thousand* Dollars (*$24,000.00*) per year, payable in twelve (12) equal monthly installments in the amount of *Two Thousand* Dollars (*$2,000.00*) each, payable by the tenth (10th) day of each and every calendar month hereafter during the entire term of this agreement. It is understood that such compensation shall be in addition to (and not in lieu of) any shares of commissions to which the Employee is or shall be entitled by reason of brokerage services performed by the Employee for or in behalf of the Company or any other salary which the Company may elect to pay to the Employee.

4.

In the event of the death of the Employee during the term of this agreement, the Company shall continue to pay to the estate of the Employee the compensation which would otherwise be payable to the Employee hereunder for and

---

connection therewith as might be suggested or requested by the Board of Directors of the Company.

(c) To serve, without additional compensation, as a Director or in such other office or offices of the Company to which he may be appointed or elected by the Board of Directors or the stockholders of the Company.

(d) Not to, during the effective period of this agreement, or any time within a period of ..... (.....) months after the termination hereof, divulge or disclose to any other person, firm or corporation any of the listings or prospects or other confidential information of the Company which the Employee has acquired or otherwise been made aware of during the term of this agreement; and

(e) At the termination of this agreement, to submit in writing to the Company a complete and composite list of all listings and prospects which the Employee has procured or generated or is then working on or in connection with, or which have been presented to the Employee or of which the Employee is then aware, and which relate in any manner or way to the real estate brokerage business and/or the business of the Company.

during the entire term hereof. (i.e. until September 30, 1979). ***

The Employee may, without cause, terminate this agreement upon thirty (30) days prior written notice to the Company. In such event, (i) the Employee shall continue to perform and render his services hereunder and shall be paid his regular fixed monthly compensation up to the date of such termination, and (ii) thereafter, during the period from the date of such termination until September 30, 1979, the Employee shall act as an advisor and consultant to the Company, performing such services in such capacity as may be requested from time to time by the Company, and *shall be paid therefor a monthly sum equivalent to Forty per cent (40%) of all deferred commissions actually paid to and received by the Company during the preceding calendar month, but in no event to exceed the sum of Two Thousand Dollars ($2,000.00) per month.* It is understood that the aforementioned percentage shall be payable to the Employee notwithstanding the fact that he is not called upon by the Company to perform any consulting or advisory services and shall continue to be paid to the estate of the Employee in the event of his death prior to September 30, 1979.

As with Mr. Russo, Mr. Shindler agreed, inter alia, to compensation and consideration in the sum of $2,000 per month for 144 months; Mr. Cummins agreed to receive $1,000 per month for the same period.

In 1967, RSC had deferred commissions amounting to $708,473. These commissions represented amounts which were to be received by the corporation over the periods of various leases which had previously been negotiated by the corporation.

In order to allow the new shareholders to purchase a total of 25 percent of the corporate stock, RSC developed a plan whereby each of the original shareholders would sell 25 percent of his shares to new shareholders at a price reflecting the value of the corporation net of the deferred commissions receivable. The agreements, entitled "Employment Contract" quoted in

part above, were entered into between RSC and Messrs. Russo, Shindler, and Cummins in furtherance of the plan of RSC to take in new shareholders.

Messrs. Russo, Shindler, and Cummins each sold 25 percent of his stock for $24 per share directly to Messrs. Gustafson, Smith, and Miller. Upon completion of those sales transactions the resulting ownership of RSC was as follows:

Shareholders	Number of Shares	Percentage Ownership
Joseph E. Russo	1,875	30 Percent
James C. Shindler	1,875	30 Percent
E. J. Cummins	937.5	15 Percent
James W. Gustafson	625	10 Percent
Barry W. Smith	625	10 Percent
Fred Miller	312.5	5 Percent

On January 10, 1968, all the shareholders of RSC entered into the "Russo/Shindler, Cummins, Inc. Stock Purchase Agreement." Essentially that agreement entitled the corporation, and, subject to the right of the corporation, the shareholders to a right of first refusal should any shareholder decide to dispose of either a portion or all of his RSC stock. The relevant portions of that Stock Purchase Agreement provided:

II.

Notice. * * *

> In said notice such Stockholder shall irrevocably offer to sell and transfer such shares to the Company and, subject only to the prior right of the Company to acquire any of such shares, to its Stockholders or such of them as may elect to purchase, severally or collectively, any of such shares
>
> (i) at a price per share equal to the cash price or consideration per share and on the same terms specified in such notice, or
>
> (ii) in the event that no consideration is stated by the Stockholder for such shares the price shall be the Value Per Share of such stock as determined by Section V hereof.

* * *

IV.

Termination of Association with Company. Within thirty (30) days after any stockholder shall cease for any reason to be associated with the Company in any capacity other than as a stockholder, whether upon action by the Board of Directors of the Company or otherwise, such Stockholder shall offer all such shares of stock owned of record or beneficially by him to the Company and subject only to the prior right of the Company to acquire any of such shares, to its Stockholders or such of them as may elect to purchase, severally or collectively, any of such shares at the Value Per Share as determined by Section V hereof, which offer shall be irrevocable for a period of ninety (90) days after the date of receipt. During such ninety (90) day period the options between the Company and its Stockholders shall exist for one-half of the time period provided for in Section III hereof. In the event such option to purchase is not exercised by the Company and/or the Stockholders within said ninety (90) day period, then such Stockholders may sell, assign, transfer, pledge or otherwise dispose of such shares of stock as he may see fit.

V.

Value Per Share. The term "Value Per Share" for shares of stock purchased and sold under this Agreement shall mean (i) the pro rata part of the base value $150,000.00, plus (ii) the pro rata part of the book value of the Company to the extent such book value exceeds $30,000.00 plus (iii) the pro rata part of the excess of the market value over the book value of all assets of the Company, including securities and real property but excepting furniture, fixtures, leasehold improvements, vehicles, good will and other personal property of the Company plus, (iv) the pro rata part of all deferred commissions allocated to and retained by the Company, after December 31, 1967, plus (v) the remaining amounts which would be due or would have been earned under any employment contract in force between the retiring or deceased stockholder had such stockholder survived and/or remained a stockholder and/or

employee until the completion or expiration date of such employment contract; the employment contracts to which this provision specifically applies are those employment contracts executed between the Company and Joseph E. Russo, James C. Shindler and Edward J. Cummins, dated October 1, 1967.

The term "Book Value" as used herein shall mean the book value per share outstanding (including any shares of stock to be sold hereunder) as shown by and determined from the balance sheet of the Company prepared by the regularly employed independent certified public accountants for the Company (which balance sheet is to be certified) in accordance with generally accepted principles of accounting as of the close of business of the Company on the last day of the calendar month next preceding the calendar month during which the Company receives a notice as provided in Sections II, IV or VI hereof.

The term "market value" as used herein shall mean as to listed securities the average between the bid and asked price on the date of determination and as to unlisted securities and real property the appraised value of such unlisted securities and real property. In the determination of market values, as opposed to book value, if the parties involved are unable to agree on such market value then arbitrators appointed one by the Company and one by the selling Stockholder, or his personal representatives in the event of his death, and a third arbitrator appointed by the other two arbitrators shall arrive at such market value, which determination shall be conclusive and binding.

Early in 1969, Mr. Russo decided to completely terminate his employment and shareholder relationships with RSC. At the same time Mr. Gustafson resolved to sell his entire RSC stock holdings. Accordingly, a Termination Agreement dated February 27, 1969, was executed on March 19, 1969, with a retroactive effective date of January 31, 1969. That contract set forth numerous provisions confirming Mr. Russo's and Mr. Gustafson's withdrawals from the corporation. In pertinent part, the Termination Agreement stated:

II.

Purchase of Company Stock

A. *Agreement to Purchase.* For the considerations hereinafter stated and subject to the remaining terms and provisions hereof, Russo and Gustafson hereby agree to sell and convey to the Company, and the Company does hereby agree to purchase and acquire from Russo and Gustafson, a total of 2,500 shares of the capital stock of the Company (the "Company Stock"), consisting of all of the capital stock of the Company owned by Russo and Gustafson, collectively, and consisting of 1,875 shares owned by Russo (the "Russo Company Stock") and 625 shares owned by Gustafson (the "Gustafson Company Stock"), which shares represent, respectively, 30% and 10% of all of the issued and outstanding capital stock of the Company. Russo and Gustafson shall hereinafter sometimes collectively be referred to as "R&G" * * *.

B. *Consideration.* As consideration of the purchase of the Company Stock, the company shall pay and assign or cause to be paid or assigned to R&G the following:

1. A sum equal to the "Value Per Share" multiplied times the number of shares of the Company Stock, all as computed and determined in accordance with the Stock Purchase Agreement (the "Stock Purchase Agreement") entered into between the Company and its stockholders under effective date of January 10, 1968, which determination shall be made by the accountant for the Company, Edgar L. Bauer, as of the Effective Date and shall be subject to verification (but not audit) by R&G and/or an accountant designated by R&G; * * *.

* * *

The sums payable to Russo and Gustafson, respectively, as determined in accordance with the foregoing provisions of this Paragraph B are hereinafter referred to collectively as the "Base Purchase Price" and individually as the "Russo Base Purchase Price" and the "Gustafson Base Purchase Price".

* * *

C. *Payment of Base Purchase Price.* Subject to the credits and deductions set forth below and to the remaining provisions hereof, the Base Purchase Price shall be payable to Russo and Gustafson, respectively, at the time of closing hereof, as hereinafter specified, as follows:

1. *To Russo.*

(a) A sum equal to 15% of the Russo Base Purchase Price shall be payable in cash at the time of closing hereof, *less and except*, however, 75% of the total of the amounts to be credited to the Company as part of the sale by the Company to R&G of certain leasehold improvements, furniture and other personal property as provided in Article III below; and

(b) The balance of the Russo Base Purchase Price is to be evidenced and payable in accordance with the terms of a promissory note of the Company in such amount, to bear interest at the rate of 4% per annum, and to be payable to the order of Russo in ten (10) equal semi-annual installments of principal, plus accrued interest commencing with August 1, 1969, which note (the "Russo Note") shall be secured by a pledge and security agreement (the "Russo Stock Pledge") covering the pledging the Russo Company Stock, which pledge and security agreement shall reserve and retain in the Company (until an event of default occurs thereunder), all voting and dividend rights and privileges with respect to the Russo Company Stock:

provided, however, that that portion of the Russo Base Purchase Price payable by reason of deferred commissions allocated to and retained by the Company for the period from January 1, 1968, to December 31, 1968 (and included in the determination of the "Value Per Share" as provided in the Stock Purchase Agreement) shall be *excluded* from the aforesaid 15% cash down payment and promissory note of the Company, and, instead, such commissions shall be payable only if, as and when the same are actually paid to and received by the Company, less and except a servicing fee of 20% thereof for cost of servicing and collection, all as

provided and set forth in the form of letter agreement to be entered into between the Company and Russo attached hereto as Exhibit "B" and made a part hereof for all purposes. * * *

* * *

VIII.

* * *

B. *Resignations of Russo and Gustafson.* Russo and Gustafson hereby resign as officers and directors of the Company, the Management Company, and the Northwest Management Company, all as of the Effective Date. Russo further agrees that that certain employment contract entered into between Company and Russo effective as of October 1, 1967, is and shall be fully terminated and cancelled effective as of the Effective Date.

Pursuant to the Termination Agreement, Mr. Gustafson actually terminated his shareholder status by selling all of his RSC stock to the corporation. The company's accountant calculated that RSC owed Mr. Gustafson $36,243.27 for its redemption of his 10 percent shareholder interest.

Similarly, in accord with the Termination Agreement Mr. Russo in fact resigned his position as an executive officer and director of RSC, sold to the corporation his entire 30 percent share of RSC capital stock, and cancelled his Employment Contract with the company. The RSC accountant determined that in return the corporation owed Mr. Russo $364,729.79. The accountant's calculations were detailed as follows:

Sale of Stock To Shindler/Cummins 1-31-69

Total per Agreement	$364,729.79
Less deferred commissions to be collected	(43,554.38)
Add: deferred commissions actually collected	6,516.26
	$327,691.67

Detail of Total per Agreement

Book Value 1-31-69		$ 95,288.14	
Plus: Income on same as developed by K.W.M. on attached list of 4-6-69		1,963.22	
Less: Item (ii) Part V ..		(30,000.00)	$ 20,175.41
Base value — Item (i) Part V			45,000.00
Plus: Increase in deferred commission after 12-31-67			
Balance 12-31-67 ..	$605,692.00		
Balance 1-31-69 ...	787,168.59		
Increase	$181,476.59		
Less: 20% collection and Service Cost.	36,295.32		
	$145,181.27		
x 30% (Mr. Russo's percentage ownership of RSC)			43,554.38
			$108.729.79
Balance due under the employment contract			
To interest owned by Russo only — Original balance 144 months at $2,000.00 per month	$ 288,000		
Less: amount paid thru 1-31-69 (16 months at $2,000.00)..	32,000	256,000.00	
Total Interest Per Agreement			$364,729.79
Payable at 15% down and Balance in 10 semi-annual installments plus interest at 4% per annum			
Down	$ 54,709.47		
Per year	$ 62,004.06		

Mr. Russo collected $54,600 under this agreeemtn in each of the years 1970, 1971, and 1972 and collected $81,900 in 1973.

In their income tax returns for the respective years petitioners reported the full amounts received as payments for the redemption of Mr. Russo's RSC stock. As a result, petitioners claimed long-term capital gains of $51,778 in each 1970, 1971, and 1972 and $77,666 in 1973 from the sale of the stock. Respondent recharacterized a portion of each year's collections as ordinary income by allocating $256,000 of the total $364,729.79 to payment for the termination of an unexpired portion of Mr. Russo's Employment Contract with RSC. The adjustment resulted in the following:

Year	Ordinary Income from Termination of Employment Contract (78.12 Percent)	Capital Gain from Sale of Stock (21.88 Percent)
1970	$42,653.52	$ 9,123.53
1971	42,653.52	9,123.53
1972	42,653.52	9,123.53
1973	63,980.28	13,685.29

OPINION

The only issue for our decision in this case is whether an amount received by Mr. Russo from RSC is attributable in its entirety to the redemption of corporate stock, entitled to capital gains treatment, or whether a portion of that payment constitutes recompense for the termination of an unexpired Employment Contract with the corporation, which share would be subject to ordinary income treatment.

Pursuant to the Termination Agreement, in 1969 Mr. Russo terminated his RSC employment and sold his entire 1,875 shares of RSC capital stock to the corporation. under the agreement Mr. Russo was to receive from RSC $364,729.79 over a term of years.

Petitioners argue that all moneys received by Mr. Russo under the agreement were attributable to the sale of stock, a capital

asset. They assert that RSC used a fixed formula price in its determination that it owed Mr. Russo $364,729.79 upon his terminating his RSC interests. Termination Agreement Article II(B)(1) referred to that fixed formula price as "Value Per Share" computed and determined in accordance with Article V of the Stock Purchase Agreement. While respondent concedes that Article V(i) through (iv) might represent a valuation of shares on a per share basis, he views Article V(v) as being wholly separate and ineffective for valuing an individual share of stock. Instead, respondent argues that Article V(v) bound RSC to pay an additional fixed sum to any original shareholder for terminating his unexhausted Employment Contract.

Petitioners attempt to refute respondent's position that Article V(v) does not affect the per share valuation of the RSC stock by arguing that the "Employment Contract" referred to therein is not what it purports to be. Petitioners urge us to overlook the contractual label and for n of the Employment Contract. They contend that the substance of the transaction when viewed in its entirety shows that the agreement entitled "Employment Contract" was not in fact a contract of employment.

Mr. Russo and the RSC Certified Public Accountant testified that the parties to the "Employment Contract" substantively intended it as a device to directly and temporarily reduce the per share valuation of RSC stock. By assessing the shares' worth net of corporate deferred commissions to be received on leases existing on December 31, 1967, the original shareholders envisioned attracting prospective shareholders at affordable prices while using the "Employment Contract" to protect the original three shareholders' proportionate interests in the pre-December 31, 1967, deferred commissions.

Petitioners argue that Article V(v) of the Stock Purchase Agreement could have been stated as "[t]he pro-rata part of all deferred commissions allocated to and retained by the Company,

before December 31, 1967", and that interpretation would conform the Article V(v) language to the pro-rata valuation wording of subsections (i) through (iv). Petitioners contend that the language change would not alter the meaning of the Stock Purchase Agreement, but rather, it would allow Article V(v) to assume an integral role in the fixed formula per share assessment so that Article V(i) through (iv) plus subsection (v) would reflect the proper pro-rata stock valuation of any original shareholder withdrawing after December 31, 1967.

In response to petitioners' substance-over-form argument, respondent suggests that a taxpayer bears a heavy burden when attempting to repudiate the written form of a transaction to which he is a party. Respondent urges us to apply the rule of *Commissioners* v. *Danielson*, 378 F.2d 771, 775 (3d Cir. 1967), revg. 44 T.C. 549 (1965), which is:

> a party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. * * *

Neither this Court nor the Fifth Circuit to which an appeal in this case would lie has adopted the *Danielson* rule, but rather requires "strong proof" by a taxpayer to show that words of such a written agreement do not state its intent. *Schmitz* v. *Commissioners*, 51 T.C. 306, 318 (1968), affd. 457 F.2d 1022 (9th Cir. 1972); *Mittleman* v. *Commissioner*, 56 T.C. 171, 175 (1971), affd. 464 F.2d 1393 (3d Cir. 1982); *Barran* v. *Commissioner*, 334 F.2d 58 (5th Cir. 1964) affirming in part and reversing in part 39 T.C. 515 (1962); *Sonnleitner* v. *Commissioner*, 598 F.2d 464 (5th Cir. 1979) affirming a Memorandum Opinion of this Court. The Fifth Circuit in *Barran, supra* at 63, held that where parties bargain at arm's length and the resulting agreement has a separate basis in economic reality, strong proof "must be adduced to overcome the declaration" of the finalized

contract. The Court in *Sonnleitner, supra,* implied that only where the agreement lacks economic reality is the "strong proof" standard inapplicable.

Although the majority of cases incorporating the "strong proof" rule have involved convenants not to compete, several cases have applied the strong proof rule to other types of agreements. *Estate of Rogers* v. *Commissioner,* 445 F.2d 1020 (2d Cir. 1971), affirming a Memorandum Opinion of this Court (mortgage); *Stephens* v. *Commissioner,* 60 T.C. 1004 (1973), affd. 506 F.2d 1400 (6th Cir. 1974) (binding contract to purchase stock); *Pritchett* v. *Commissioner,* 63 T.C. 149, 171 (1974) (real estate sales contract). In our view the appropriate burden of proof criterion for overcoming a written agreement which has economic reality is "strong proof."

The plain language of the Russo/RSC Employment Contract endows it with economic reality independent of any other contract. As executed, without the occurrence of any condition precedent, that contract legally entitled Mr. Russo to $24,000 per year, payable in 144 monthly installments of $2,000 during the period of October 1, 1967, through September 30, 1979. That the agreement had economic reality is evidenced by the fact that pursuant thereto Mr. Russo was paid $2,000 monthly by RSC from October 1, 1967, through early 1969. Therefore, it is incumbent upon petitioners to produce strong proof to overcome the presumption that the Employment Contract is anything other than its title and wording suggest.

The clear wording of Articles 3 and 4 of the Employment Contract created RSC's liability to compensate Mr. Russo in consideration for services performed and to be performed. The payment schedule was arranged as a flat salary payable in equal monthly installments to Mr. Russo in addition to commissions or other compensation to which Mr. Russo might be entitled. It provided for Mr. Russo to act as an advisor to RSC if called

upon to do so upon termination of his regular employment by RSC.

Even though the parties to the Termination Agreement never specifically bargained for monetary consideration to be paid upon the termination of any employment contract, the legal effect of the terminology of this contract is so clear that no such bargaining was necessary. The Termination Agreement Article VIII(B) coupled with the Stock Purchase Agreement Article V(v), which is incorporated in the Termination Agreement, induced an acceleration of the compensation payment schedule rather than nullifying or supplanting that contract.

The language of the Employment Contract required the corporation to pay Mr. Russo the $24,000 per year for the unexpired portion of the contract. In our view, nothing in the Stock Purchase Agreement changes this obligation of the corporation. That agreement in effect merely provides that the corporation may purchase the employees' rights under the Employment Contract. This view of the Stock Purchase Agreement is borne out by the provision of the Termination Agreement that Mr. Russo "further agrees that that certain employment contract entered into between Company and Russo effective as of October 1, 1967, is and shall be fully terminated and cancelled effective as of the Effective Date."[3]

The fact that in accordance with his Employment Contract Mr. Russo received monthly installments of $2,000 from October 1, 1967, until his 1969 employment termination, further sustains our conclusion. Moreover, petitioners neither contended nor proved that on their 1967, 1968 and 1969 Federal income

---

[3] Certainly had another stockholder rather than the corporation purchased Mr. Russo's stock, that stockholder would not have paid Mr. Russo "the remaining amounts which * * * would have been earned [by Mr. Russo] under any employment contract in force * * *" Between Mr. Russo and the corporation without receiving for such payment an assignment of Mr. Russo's rights under his Employment Contract.

tax returns they attributed those $2,000 monthly receipts to any source apart from compensation, commissions, or other ordinary income items. Presuming that petitioners regarded the 1967 through 1969 installments as ordinary income, their 1970 through 1973 income tax treatment was inconsistent with the prior years' handling of these amounts.

Petitioners further seek to persuade this Court that the Employment Contract constituted a part of the stock's per share valuation by asserting that all parties, not just petitioners, shared in the positive and negative tax consequences of their argued allocation of funds. Petitioners reason that deferred commissions are a corporate asset which enhances the value of capital stock. *Steffen* v. *Commissioner*, 69 T.C. 1049 (1978). They argue that these commissions should be "capitalized" and treated as a portion of capital stock valuation which would result in the corporation not receiving the tax benefit of deducting the payments to Mr. Russo as a business expense. It may well be that the deferred commissions were an asset of the corporation. However, the Employment Contracts were liabilities of the corporation in the form of compensation payable. Only of incidental importance is the fact that those liabilities were tied to the asset of deferred commissions receivable, which relationship does not control the classification of the liabilities.

Furthermore, there is no evidence in this record to substantiate petitioners' contention that RSC did not claim a business expense deduction for a portion of the payments made to Mr. Russo.[4] Yet they ask this Court to accept their contention that "[i]f RSC intended to take a deduction for payments made in

---

[4] The accountant for RSC testified in an equivocal manner that he told Mr. Shindler that if the payments to Mr. Russo were for the stock, the payments were not deductible by the corporation. This testimony in no way shows that some of the payments were not deducted by the corporation. In any event, the manner in which the corporation handled the payments would not be controlling of the issue here presented.

termination of an employment contract, a provision to this effect could have been put into the Stock Purchase Agreement, or made the subject of a separate agreement." While we agree that such a provision *could* have been written into an agreement, the lack of such a clause would not preclude RSC from claiming the deduction. If RSC and its stockholders had intended to cancel the Employment Contracts when the Stock Purchase Agreement was entered into, they could have written the agreement to state that which petitioner claims it was meant to state. They did not do so.

Lastly, petitioners argue that the discrepancy in the moneys received by Mr. Russo and Mr. Gustafson upon the sales of their stock holdings to RSC is attributable to the prior creation of two classes of capital stock. Mr. Gustafson received $36,234.27 for the redemption of his 10 percent interest in RSC. Comparatively, Mr. Russo, who had a 30 percent interest in the corporation, received $364,729.79. Respondent contends that if Mr. Russo were being paid solely for his 30 percent stock ownership, he would have received $108,729.79, three times the amount received by Mr. Gustafson. Petitioners claim that the entire $256,000 difference ($364,729.79 minus $108,729.79) is ascribable to the capitalization of corporate deferred commissions receivable before December 31, 1967, the amount presumably agreed upon to enhance the value of Mr. Russo's stock. Petitioners contend that because the RSC stock holdings of Messrs. Russo and Gustafson were redeemable at varying prices, the corporation created a second class of stock by informal actions when the Employment Contracts were executed.

The Revised Civil Statute, State of Texas, Busines Corporation Act, Article 2.13A(2), allows for the creation of a special class of stock based upon "the price at and the terms and conditions on which shares may be redeemed". However, Articles 2.12 and 2.13A require that the articles of incorporation specifically provide for the creation of such special classes of stock.

While petitioners' argument that actions can create a second class of stock without the formal processes is not necessarily incorrect, petitioners have not shown that a second class of stock was actually created. The record is devoid of any showing that the Articles of Incorporation of RSC allow for the creation of a special class of stock. Moreover, the accountant for RSC testified that when Mr. Russo sold his RSC shares to the corporation not more than one class of stock existed.

In considering the transaction as a whole and each of its components, we are of the opinion that Mr. Russo received $108,729.79 from RSC in redemption of his capital stock. It is clear that the stock redemption effected by the Termination Agreement qualifies for capital gains treatment under Section 302(a) since the distribution was substantially disproportionate and not essentially equivalent to a dividend. On the other hand, the terms of the Employment Contract, the Stock Purchase Agreement, and the Termination Agreement give those contracts separate as well as unified legal identities. We conclude that in substance and form the disputed $256,000 is attributable to compensation and consideration received by Mr. Russo upon termination of the unexpired portion of his Employment Contract. Petitioners effectively would have us rewrite the contracts now because in retrospect the agreements could have been written differently. There is no basis in this record for such a rewriting of the agreements. We therefore hold that the payments received by petitioners on the $256,000 paid for termination of their Employment Contract in each of the years here in issue constitute ordinary income.

Because of the settlement of certain issues,

Decisions will be entered under Rule 155.

Opposition

Office - Supreme Court, U.S.
FILED
OCT 9 1981
ALEXANDER L. STEVAS,
CLERK

No. 81-355

In the Supreme Court of the United States

OCTOBER TERM, 1981

JOSEPH E. RUSSO AND SALLY S. RUSSO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Page

Cases:

Commissioner v. *P.G. Lake, Inc.*, 356 U.S. 260 5

Dixie Finance Co. v. *United States*, 474 F. 2d 501 5

Gregory v. *Helvering*, 293 U.S. 465 5

Higgins v. *Smith*, 308 U.S. 473 5

Roscoe v. *Commissioner*, 215 F. 2d 478 4

Spector v. *Commissioner*, 641 F. 2d 376 5

Ward v. *United States*, 456 F. 2d 354 4

Wood v. *Commissioner*, 34 T.C.M. (CCH) 817 4

Statute:

26 U.S.C. 302(a) 4

In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-355

JOSEPH E. RUSSO AND SALLY S. RUSSO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In this federal income tax case, petitioner[1] seeks review of the decision below holding that a portion of the payments received by him after he severed his relationship with Russo/Shindler, Cummins, Inc., was paid for by the termination of his employment contract, and therefore was taxable as ordinary income, rather than as long-term capital gain attributable to the redemption of his stock.

The pertinent facts may be summarized as follows: In 1967, petitioner was one of three shareholders of Russo/Shindler, Cummins, Inc. (RSC), a corporation engaged in the real estate business. In that year, RSC had deferred commissions receivable totaling $708,473 (Pet. App. A-1). To permit three new shareholders to purchase a total

---

[1]Sally S. Russo is a party solely because she filed a joint income tax return with Joseph E. Russo for the tax years at issue. References to petitioner are to Joseph E. Russo.

of 25% of RSC's stock at a price reflecting its value, less deferred commissions receivable, each of the three original shareholders entered into an employment agreement with RSC providing for the payment to each, over time, of an amount approximating his pro rata interest in the receivables. Petitioner's employment contract entitled him to receive a total of $288,000 payable in monthly installments of $2,000. In exchange, he was obligated to perform services as an employee, or, if he left the company, as an advisory and consultant services. Payments were to continue even upon petitioner's death (Pet. App. A-1 to A-2).

Subsequently, petitioner and the other two shareholders sold 25% of their stock to the three new shareholders. Petitioner's stock ownership in RSC was accordingly reduced from 40% to 30%. One of the new shareholders, James W. Gustafson, owned 10% of RSC's stock (Pet. App. A-2).

On January 10, 1968, all six of RSC's shareholders entered into a stock purchase agreement, granting RSC, and then the other shareholders, rights of first refusal, in the event any shareholder desired to sell his stock (Pet. App. A-2). The stock purchase agreement contained a formula to determine the value per share (Pet. App. A-2 to A-3).

Approximately one year later, petitioner and Gustafson decided to terminate their relationship with RSC. Accordingly, a Termination Agreement, dated February 27, 1969, was executed by RSC, petitioner, and Gustafson. The agreement specified that petitioner and Gustafson were to sell their shares to the corporation at a price per share determined by the formula contained in the stock purchase agreement. That formula provided that the value per share equaled (1) a pro rata share of RSC's basic value of $150,000, plus (2) a pro rata share of RSC's book value in excess of $30,000, plus (3) a pro rata share of the excess of RSC's market value over the book value of all but specified

assets, plus (4) a pro rata share of all deferred commissions after December 31, 1967. In addition, the formula called for the payment of an additional sum, not measured per share, equal to the remaining amounts due on the above-mentioned employment contracts. The Termination Agreement also specified that petitioner agreed to terminate his employment contract (Pet. App. A-3 to A-4).

Pursuant to the Termination Agreement, RSC's accountant calculated that Gustafson was entitled to $36,243.27 for his 10% stock interest. Petitioner sold his 30% stock interest to RSC and canceled his employment contract. In return, he was entitled to receive $364,729.79. This calculation of the amount due petitioner specifically included the remaining balance of $256,000 due on the employment contract (Pet. App. A-4, B-10 to B-11).

During 1970-1973, petitioner received partial payments of the total amount due under the Termination Agreement. He reported the full amounts received in each year as capital gains paid in redemption of his stock. On audit, the Commissioner of Internal Revenue determined that $256,000 of the total due petitioner was for the termination of his employment contract and, therefore, an appropriate percentage of each year's receipts was ordinary income (Pet. App. A-4).

Petitioner thereafter brought this proceeding in the United States Tax Court for redetermination of the ensuing deficiencies. After considering the transaction as a whole, and each of its components, the Tax Court held that in substance and in form the $256,000 was paid as consideration for the termination of petitioner's employment contract. Accordingly, it ruled that a portion of petitioner's receipts in each of the years at issue was ordinary income (Pet. App. B-19). The court of appeals affirmed (Pet. App. A-4).

1. The decision below correctly held that a portion of petitioner's proceeds upon the severance of his relationship with RSC was ordinary income paid for the termination of his employment contract. Generally, a shareholder is accorded capital gains treatment upon the complete redemption of his stock in a corporation. Section 302(a) of the Internal Revenue Code of 1954 (26 U.S.C.). If the redeemed shareholder is also an employee of the corporation, he may at the same time receive compensation for past or future services to the corporation. Such payments are ordinary income. *Roscoe* v. *Commissioner*, 215 F. 2d 478 (5th Cir. 1974); *Ward* v. *United States*, 456 F. 2d 354 (6th Cir. 1972). If a portion of the shareholder-employee's receipts are for the termination of an employment contract, that portion is also ordinary income. *Roscoe* v. *Commissioner, supra; Wood* v. *Commissioner*, 34 T.C.M. (CCH) 817 (1975).

This case posed only a factual question concerning whether a portion ($256,000) of petitioner's total payment of $364,729.79 was to terminate RSC's $256,000 liability on his employment contract or was for the redemption of his stock. On the facts, the decision below held that, in both substance and form, $256,000 of the proceeds due petitioner was for the cancellation of his employment contract.

The rulings of both courts below were based on substantial, indeed overwhelming, evidence. At the same time that petitioner's stock in RSC was redeemed, Gustafson sold his 10% stock interest to RSC for $36,243.27. Petitioner sold his 30% stock interest in the company and canceled his employment contract for a total amount precisely equal to three times the amount paid Gustafson ($108,729.79), plus the $256,000 remaining liability on his employment contract. Moreover, although the Termination Agreement provided that all of the consideration due petitioner was for stock, it also provided that the price for the stock equaled

the number of shares multiplied by the value per share (Pet. App. B-8). While the first four components of the formula reflect a per share valuation, the fifth component calls for an aggregate payment of the remaining sum due on petitioner's employment contract. This element is unquestionably a payment to petitioner with respect to the amount due on his employment contract.

The courts below accordingly rejected petitioner's contention that all of the consideration was for his stock and none of it was for the cancellation of his employment contract. In so holding, the decision below relied on the established principle that the Commissioner of Internal Revenue may disregard the form of a transaction if it does not comport with economic reality. *Higgins* v. *Smith*, 308 U.S. 473, 477 (1940); *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *Commissioner* v. *P.G. Lake, Inc.*, 356 U.S. 260, 266-267 (1958); see *Spector* v. *Commissioner*, 641 F. 2d 376 (5th Cir. 1981); *Dixie Finance Co.* v. *United States*, 474 F. 2d 501, 504 (5th Cir. 1973). Petitioner's contention (Pet. 4) that the Commissioner may not do so unless the transaction was not at arm's length, was a sham, or had no purpose other than to avoid taxes does no more than state some of the factors utilized in determining whether an agreement reflects economic reality.

2. Petitioner alternatively contends (Pet. 5-6) that the agreement he entered into with RSC was not really an employment agreement even though it was so styled. But the court of appeals correctly rejected petitioner's disavowal of his own agreement because he had shown "strong proof" neither that the agreement was not what it purported to be (*Dixie Finance Co.* v. *United States, supra*, 474 F. 2d at 505), nor that there was a mistake, overreaching, duress or other reason sufficient to invalidate the agreement in an action between the parties (*Spector* v. *Commissioner, supra*, 641 F. 2d at 385-386). Since petitioner's argument

fails under either standard, there is no occasion for this Court to determine which standard is properly applicable here, even assuming that these tests might be mutually exclusive.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

OCTOBER 1981

DOJ-1981-10